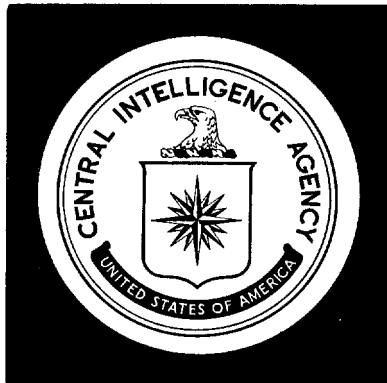


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Foreign Reaction to the New US Economic Policy

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November 1971

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Note

This memorandum evaluates foreign reaction to the US economic policy announced on 15 August, the economic and political impact abroad, and the likely responses of foreign countries [REDACTED]

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[REDACTED] It was prepared jointly by the Office of Economic Research and the Office of National Estimates with contributions from the Office of Current Intelligence. It has not been coordinated with any other part of the US Government.

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INTELLIGENCE MEMORANDUM

FOREIGN REACTION TO THE NEW US ECONOMIC POLICY

Summary

The US new economic policy (NEP) came as a shock to the international community. There was widespread apprehension that the 10% import surcharge would have immediate disruptive effects. Strong criticism of the proposed job development tax credit and Domestic International Sales Corporation (DISC) was also voiced. Most official reactions generally recognized, however, that the United States had to take drastic action to improve the performance of its domestic economy and restore its international payments position. Indeed, some of the West European industrial countries had long insisted that Washington take corrective measures to balance its foreign payments. But what these countries had advocated was tighter US monetary policies which would stem the outflow of capital to Europe -- there was little disposition on their part to make large adjustments on the trade account.

The initial adverse reactions to the NEP were tempered by hopes for a quick settlement of the underlying issues. But as such hopes have been disappointed and it has appeared that the impasse could continue for some time, there has been growing concern about the future. There is fear of the combined effects of instability in foreign exchange markets, the possibility of competitive trade restrictions, and a US retreat into protectionism and isolationism.

Economic Impact

The economic impact of the NEP on foreign countries has so far been small, but there is danger that it will become considerably larger in the coming months if the impasse continues. This is in part because the NEP caught most industrialized countries at a sensitive moment of economic transition. A slowdown was under way in West Germany and in some smaller European countries as part of official programs to ease inflationary pressures and uncomfortably tight labor markets. Inevitably, some business and labor leaders were worried that their governments would prolong "stabilization" into "recession." In Italy, strikes, large wage increases, and political uncertainty had nearly halted economic expansion. In Japan, the government was just beginning to stimulate an economy whose growth had

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slowed greatly. In Britain, expansionary policies were expected to produce an upturn in a stagnating economy, although few signs were yet evident to the electorate. Canada, although recovering from its recession, still had a higher unemployment rate than the United States because of its rapidly growing labor force.

In this environment the NEP has had a large psychological impact throughout the world and has contributed to an emerging crisis of economic confidence. Uncertainty about exchange rates troubles those who make investment decisions, and there is general apprehension about the long-range future of international trade. The West Germans and the Japanese are the most upset; the relatively large appreciation of their currencies,⁽¹⁾ combined with general economic uncertainty, has created concern about export prospects which, at least in Germany, seems to be developing into a "recession mentality." All over the industrialized world, investment is off, order books are thinner, and estimates of GNP growth are being revised downward.

This nervousness about the economic future has potentially serious repercussions on the less developed countries. Only a few of them send substantial exports of manufactured goods to the United States, and many of these are cheap enough to absorb the surcharge and remain competitive. But an economic slowdown in the industrialized world would reduce demand for the industrial raw materials which are the backbone of Third World export earnings and whose sales already are down, partly because of the US recession. The less developed countries already are reflecting the anxieties afflicting the industrialized world, and they are further shocked by what appears to them as a sudden reversal of Washington's foreign economic policy.

In the economically advanced areas of the world, the potential economic impact of the US actions as such varies considerably from country to country [redacted] The import surcharge, together with the Canadian dollar's float in the past year, has serious implications for Canada's manufacturing development. Lacking substantial foreign markets outside the United States for much of its manufacturing exports and some of its raw materials, Canada has little choice but to strike a bargain with the United States. Some Japanese exporters will suffer, especially those small and medium-sized enterprises that turn out "sundry goods." But Japan's most important exporting industries are sufficiently competitive to absorb the impact of the surcharge. In Western Europe, the potential economic damage is relatively small. Some of Europe's growth industries will be affected -- perhaps more by the proposed investment tax credit than by the surcharge.

1. In the case of West Germany, before and since the NEP.

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But few West European countries send as much as 10% of their exports to the United States, and most send considerably less. All could prosper if they kept up a brisk level in their far more important trade with each other.

Political Effects

The NEP has created -- or added to -- domestic political problems for some of Washington's allies. The prime example, of course, is Japan's Prime Minister Sato. Sato's troubles with Washington may cause him to leave office sooner than he would have liked. Whoever succeeds him probably will continue Sato's basic policies, but is likely to want to distance himself from Washington at least in appearances. Some ammunition has been given to "anti-Americans" throughout the world, but we cannot now identify any situation other than the Japanese in which the Washington measures are likely to bear directly on the life expectancy of any existing government. But prolonged, the measures could aggravate the economic troubles which already are prime political issues in West Germany, Italy, Canada, and Great Britain. Washington's share of the "blame" for those troubles would be greater than its actual contribution to them.

Perhaps the political effect of widest significance is an increased sense of urgency about European unity. The spectre of US protectionism should help the governments in Britain, Norway, and Denmark to "sell" European Community (EC) entry to their electorates. It also hardens the determination of the "EFTA neutrals" to make industrial free trade agreements with the enlarged EC. Within the EC, the French role has been substantially strengthened. France has less political desire or economic incentive than most West Europeans to resolve the current economic difficulties. Thus those EC members who want European unity vis-a-vis the United States on, for instance, currency realignments, are likely to have to accept many of the French terms. The domestic heat is on the West German government to disprove the charge that its eagerness to accommodate the United States has led to a weakening of West European, and especially Franco-German, ties.

Probable Responses

The NEP already has produced general agreement on the need for worldwide currency realignments. The most striking switch is in the attitude of Japan, which now seems willing to appreciate the yen by as much as 15%. While a lot of disagreement still exists over the particulars, it is generally accepted that Japan and West Germany, and to a lesser extent Canada, will make the largest upward adjustments from the old parities. But there is no indication that foreign governments will do much more unilaterally than they already have.

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Most foreign governments believe that if the surcharge is not lifted by early 1972, it will stay on through the US elections. They fear that by that time, everyone's relations with Washington will have changed for the worse – and maybe the political fortunes of some of Washington's friends as well.

Pressure is growing in the EC for a restoration of normal conditions for intra-EC trade and for a resumption of progress toward economic unity and monetary union. The member countries clearly prefer a currency alignment on a global basis, which would include a devaluation of the dollar in terms of gold. But if no settlement is reached within the next few months, they are likely to establish fixed parities among themselves.

The principal obstacle to such a step has been Franco-German disagreement over the EC currencies' link to the dollar. The Germans favor a joint float, while the French insist on fixed rates based on the present gold parity of the franc. The French are in the stronger bargaining position: with their economy in good shape, they can afford to wait. The Germans – whose currency has appreciated more than others in Europe and who are threatened by a recession – cannot let the present situation continue for long. A compromise is likely but almost certainly on terms closer to French than to German desires.

With an EC settlement, the countries applying for EC membership could be expected to realign their parities with those of the EC, and the Japanese might unilaterally revalue the yen. Such EC and Japanese revaluations would not be as great as could be achieved in a global settlement. And because most of the trade of an enlarged EC would be among the member countries, agreement on new parities within the EC would reduce economic pressures for an accommodation with the United States.

To facilitate a global settlement, the Japanese and West Germans probably would agree to some additional sharing of the defense burden, but Tokyo would balk at any measures – such as assuming a greater share of the cost of US forces in Japan – which would entail renegotiation of the basic US-Japanese security agreements. Japan also would resist a significant acceleration of existing plans to lower its barriers to imports and capital inflows.

We do not think the West Europeans will agree to unilateral trade concessions. They will neither change the essentially protectionist Common Agricultural Policy nor relent on their determination to bring the "EFTA non-applicants" into an industrial free trade area with the EC. If anything, developments in US-European relations since 15 August have created a sense

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of need to strengthen European institutions as a bulwark against a menacing outside world.

In a more general sense, Washington's success in handling its domestic economic readjustments and the atmosphere of its international discussions may prove equally as decisive for the US world position as the international economic arrangements which evolve. Some of the understanding and sympathy which the US problem was accorded last August is beginning to erode, and this is likely to continue unless at least the outlines of a settlement are worked out at a fairly early date.

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